Economic Outlook

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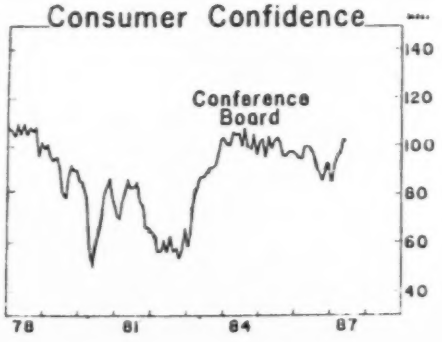
The current economic expansion has lasted for 56 months now, only two months short of the previous record for peacetime, which was the expansion between 1975 and 1980. Although it is generally agreed that a recession will not arrive soon, this expansion has certainly aged. Signs of the maturing of the expansion include the recent rise in interest rates, the acceleration of inflation, the slowdown in consumer spending, and a gradually tightening labor market. In the last two long-lived business expansions (1960-69 and 1975-80), the mature phase lasted for more than two years. We expect that the last phase of the current expansion will also be extended. As a result, our forecast foresees no economic recession until 1989.

There has been concern about the impact of the recent rise in interest rates on the economy. Rising interest rates will indeed eventually slow the economy, but it may take quite a while before they take their toll. In the 1975-80 expansion, it was not until two years and a six percentage point increase that the expansion faltered. The recent rise in interest rates is still too small and too recent to have any major negative impact on the economy.

There has also been a lot of concern about consumer spending leveling off in recent quarters. In this mature stage of a business expansion, a slowdown in consumer spending growth should be expected. After years of vigorous spending, consumers have satisfied most of their demand for cars and other consumer durables, and in the meantime have strained their financial position. Although consumers will no longer drive the economy, a collapse of consumer spending seems quite unlikely either. As the following chart shows, consumer confidence remains strong, buoyed by the favorable employment situation. The sharp declines in the unemployment rate in recent months signal a tightening labor market, and likely portend an acceleration in wage increases by year-end. Consumer income will also get an additional boost from the $40 billion reduction in individual income taxes next year as tax reform takes full effect.



Instead of being led by consumers, the last phase of the current expansion will be driven by steady improvement in our trade balance and stronger business investment. Because there is a long lag between exchange rate adjustments and their effect on the trade balance, the recent narrowing of our trade deficit in volume terms largely reflected only the effect of 1985's dollar depreciation.

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Since then, the dollar has depreciated by another 18%. Even in the unlikely event that the dollar bottoms out at current levels, substantial trade improvement remains in the pipeline. The climate for business investment is also turning favorable, paving the way for a pickup in capital spending in 1988. Corporate profits are expected to improve substantially this year as a result of reduced pressure from foreign competition and selective price increases. Although capacity constraints are not yet present in general, they are already quite intense in certain industries, such as textiles and paper. The consistent upward revision in corporate capital spending plans for 1987 also suggests rising confidence in the business sector.

In summary, the economic expansion which began in 1982 has entered a mature phase. A cyclical upturn in inflation and interest rates is expected in this last phase of the expansion. Nonetheless, the expansion is unlikely to be halted by higher interest rates soon, as trade improvement continues to provide underlying support of the economy.

Victor Kung

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
			1986	1987			1987	1988	1985-	1986-	1987-
	II	III	IV	I	II	III	IV	I	1986	1987	1988
Consumer Spending	4.0	4.4	-0.2	-0.8	1.7	2.0	1.7	1.3	2.6	1.2	1.5
Business Investment	-0.1	-0.3	0.4	-1.2	0.8	0.2	0.3	0.2	-0.1	-0.1	0.4
Residential Investment	0.6	0.5	0.3	-0.3	0.0	-0.2	-0.2	-0.1	0.5	0.1	0.0
Change in Inventories*	-2.9	-2.4	-0.4	4.8	-2.3	0.2	0.3	0.1	-0.2	0.2	0.0
Net Exports	-3.0	-1.0	1.6	1.6	1.1	1.0	0.9	0.6	-1.1	0.8	0.6
Government Purchases*	2.0	1.6	-0.6	0.7	0.7	0.5	0.5	0.5	0.8	0.6	0.5
Real GNP	0.6	2.8	1.1	4.8	2.0	3.7	3.5	2.6	2.5	2.8	3.0

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
			1986	1987			1987	1988	1985-	1986-	1987-
	II	III	IV	I	II	III	IV	I	1986	1987	1988
Nominal GNP	2.6	6.4	1.7	9.1	6.0	8.0	8.1	7.6	5.2	6.1	8.0
GNP Deflator	1.8	3.6	0.7	4.2	3.8	4.1	4.5	4.9	2.7	3.2	4.9
Corporate Profits After Tax#	1.7	1.9	3.7	9.4	12.3	8.5	3.7	8.5	2.0	8.3	6.9

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Apr.	May.	Jun.	1986	1987	1988
Consumer Price Index** (%)	0.4	0.3	n.a.	1.1	5.2	6.1
Industrial Production (%)	0.0	0.5	0.2	1.0	2.9	3.9
Retail Sales (%)	0.3	-0.3	0.4	5.5	3.6	4.2
Auto Sales (million units, a.r.)	10.5	9.8	10.1	11.5	10.1	10.0
Housing Starts (million units, a.r.)	1.67	1.62	n.a.	1.81	1.67	1.61
Unemployment Rate (%)	6.3	6.3	6.1	7.0	6.3	5.7
Merchandise Trade Deficit ($ bn., a.r.)	-159.6	-172.8	n.a.	-166.3	-155.0	-135.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast